Islamic Banking
Myths and Facts

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THE EMERGENCE OF ISLAMIC BANKING in recent years is one of the most important trends in the economic sector, and with the estimated 1.6 billion Muslims worldwide, it's ripe for growth potential.

There has always been a demand among Muslims for financial products and services that conform to Shariah (Islamic Law). The development of viable alternatives to conventional finance increasingly enables Muslims to participate in the financial world without violating their Islamic principles and without bearing the economic penalty that comes from non-participation, especially with the recent growth of oil prices.

Currently, the Islamic banking industry consists of several hundred billion dollars, and more than 300 financial institutions in and outside the Muslim world. According to Alexander Lis, managing director at the consulting firm Oliver Wyman, there is $300 billion in assets managed according to Islamic principles, ranging from commercial to investment banks and investment funds, all providing Islamic products.

Others estimate the industry to be even larger. Financial Services Authority, the financial services regulator in the United Kingdom, for example, recently suggested Islamic banking was as large as $500 billion. Standard & Poor's, a rating agency, estimates that the *sukuk* (deed) market has reached $70 billion, and will top the $160 billion mark by the end of the decade. Islamic financial services are now evolving from a niche market to the mainstream.

In addition to the sheer number of Muslims worldwide, global financial institutions are taking a strong interest in Islamic products since the industry is in its nascent stage. Products have yet to be commoditized from competition, therefore allowing profit margins to remain high.

What is Islamic banking?

Islamic banking can be considered banking with a conscience. Islamic banks each have a Shariah board made up of Shariah scholars as well as financial experts who are responsible for determining what activities are and are not Shariah-compliant.[1]

Islamic banking is based on two main financial principles. Firstly, investment is to be made in the private sector through interest-free financing. Secondly, the development of financial instruments is to be done on the basis of profit and loss sharing as well as sharing risks.

Further, Islamic banking is built around Shariah, mainly prohibiting the charging of interest. Because Islam considers interest an unjustified increase of capital, with no effort made to earn it, it is considered of false value, and therefore is prohibited. However, there are many arguments about the prohibition of interest in Islam. The first argument is that interest rates have no moral foundation. The second is that abstinence from consumption is not a justification of rewards. Lastly, some argue that there are risks to justify the supplement of payment for capital lending if the loan is guaranteed.

There has always been a demand among Muslims for financial products and services that conform to Shariah (Islamic Law).

In addition to the prohibition of interest payments, Islamic law treats money strictly as a medium of exchange. In other words, money, in itself, does not have any inherent value, and therefore it should not lead to the production of more money.[2] In Islamic banking, the creditor/debtor relationship is defined differently than in the secular financial world. The creditor, or provider, of funds who becomes a partner in a project assumes the risk activity with the entrepreneur and shares profits as well as losses. The creation of incremental wealth justifies the share of profit between the borrower and the lender of money, but does not guarantee a fixed return.[3]

1 Michael Silva, "Islamic Banking Remarks" *Law and Business Review of the Americas*; (Spring 2006).
2 Mondher Bellalah and Siwar Ellouz, "Islamic Finance, Interest Rates and Islamic Banking: A Survey of the Literature," *Finance India* (April/May 2004).
3 Ibid.

Some of the principle instruments involved in the aforementioned form of resource mobilization include the following:

- Trade financing and cost-plus mark-up on traded goods (*murabaha*).
- Profit-sharing (*mudarabah*) and equity participation (*musharaka*) in which cost-sharing among partners is also included.
- Rental on purchased equipment (*ijara*).
- Islamic banking portfolio using secondary financing instruments, such as shares and stocks revolving around the above-mentioned instruments.

	ISLAMIC BANKING	CONVENTIONAL BANKING
Main Principle	The customer shares the profit and loss with the bank. High degree of risk with variable returns.	The customer obtains fixed interest from the banks and does not share the loss.
Stability	Higher degree of stability.	Lower degree of stability.
Treatment of interest	Uses Profit and Loss Structure (PLS) accounts. Interest is prohibited.	Interest based on products.
Profitability	PLS is based on partnership (*musharaka*) or joint investment without participation in management (*mudharaba*). Based markup principle. Leasing contrast (*ijara*).	Higher concentration leads to higher interest rates which leads to higher profitability. Higher rates of inflation lead to higher profit margins.

Conventional vs. Islamic banking

An Islamic bank is similar to a modern Western bank in almost all functions which empower it to mediate any shortcomings or surpluses that may exist in a monetary exchange economy.[4] The Islamic bank requires a careful management team to balance the different levels of credit (personal credit, secured credit, letters of credit), and also functions as a specialist in estimating projects risks and estimated returns.

The main difference between Islamic and conventional banks lies in the fact that conventional banks charge and pay interest, whereas Islamic banks do not as they con-

4 Farhad F. Ghannadian andGautam Goswami, "Developing economy banking: the case of Islamic banks," *International Journal of Social Economics* (2004).

sider interest as *riba* (prohibition outlined in the Quran). Despite such, Islamic law does not require that the seller of a product be Muslim, or that its services also be Islamic.

How do Islamic banks work?

Since Islamic banks prohibit interests, the bank acts like an investment company, selling its stocks to the public. In this concept the bank does not have maturity-matching problem or duration gap management, which is a functional problem with Western banks in general.[5]

Islamic finance is fundamentally different from conventional finance as it is based on a profit and loss structure (PLS), which requires a financial institution to invest with a client in order to finance their needs, rather than lending money to their clients. By offering PLS accounts, banks and clients act as joint investors, and returns are handed out based on the profits earned by the bank or its investments. This risk-sharing is the key component of Shariah-complaint finance.[6] In order to assure customers that the structure of the Islamic products offered are complaint with Islamic law, Islamic institutions employ a panel of Islamic scholars as a Shariah board, who analyze and approve of a product's compliance with Shariah.

Islamic financial products

From the resolution passed at the Fifth Meeting of the Islamic Fiqh Academy, on Dec. 10-15, 1988, Islamic financial products are defined as follows:

> *Ijara:* Letting or lease is a sale of a definite usufruct of any asset in exchange of definite reward. It refers to a contract of land or other asset leased at a fixed rent payable in cash, a mode of financing which is also adopted by Islamic banks. It is an arrangement under which Islamic banks lease equipment, buildings and other facilities to a client against an agreed rental lease. The lessee generally also has an option to purchase the leased asset. *Ijara* is a contractual agreement comparable to a sale/lease back, where the bank buys and then immediately leases an asset to a customer for a fee. The duration of the lease and the fee is set in advance, and are in many terms comparable to the terms that may be applied to the loan.[7]
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> *Mudaraba*: A form of partnership where one party provides the funds while the other provides expertise and management. Any profits accrued are shared be-

5 Ibid.
6 Silva, "Islamic Banking Remarks."
7 Ibid.

tween the two parties on a pre-agreed basis, while loss is borne by the provider(s) of the capital. *Murabaha* is a cost-plus sale type of arrangement, where a bank purchases an asset on behalf of a customer with the understanding that the customer will repurchase the asset back from the bank. The bank's price to the customer includes a stated profit known to both parties, and the payments are amortized across a payment period, similar to a secured loan.[8]

Salam: A contract in which advance payment is made for goods that will be delivered at a later date. The seller undertakes to supply specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. According to normal rules of Shariah, no sale can be affected unless the goods are in existence at the time the deal is made, but *Salam* sale forms an exception to that rule.

Istisna': A contractual agreement for manufacturing goods and commodities, allowing cash payment to be made in advance with a set date for future delivery, or a future payment and delivery. A manufacturer or builder agrees to produce or build a well-described good or building at a given price on a given date in the future. Price can be paid in installments, or as agreed between the parties. *Istisna'* can be used for providing the construction of houses, plants, projects, and building of bridges, roads and highways.

Musharaka: A relationship established under a contract with mutual consent of all involved parties that sharing of profits and losses will take place in a specified joint business venture. It is an agreement which the Islamic bank provides funds, along with funds from the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by every partner strictly in proportion to respective capital contributions.

Wakala: A contract of agency in which one person appoints someone else to perform a certain task on his behalf, usually against a certain fee.

Commodity Murabaha: A sale of specified commodities, through a mutual exchange, on a cost-plus profit basis. If the customer wishes to invest money with the bank,

8 Ibid.

he or she will purchase commodities at "Cost X" from "Broker A" and sell them to the bank at "Cost X" plus "Profit Y," which equals the "Contract Price." The bank will repay the "Contract Price" over a period of time.

Tawarruq: The reverse form of *commodity murabaha*, where the bank sells commodities to the customer on deferred payment at cost-plus profit. The customer then sells the commodities to a third party on spot basis and receives instant cash.

Ijara wa Iqtina: A contract where an Islamic bank finances equipment, building or other facilities for a client against a rental agreement. There is a unilateral undertaking by the bank or the client so that at the end of the lease period, the ownership of the asset is transferred to the lessee. The undertaking or the promise does not have to become an integral part of the lease contract in order to make it conditional. The rental as well as the purchase price is fixed in such a manner that the bank receives back its cost price along with some profit, which is usually determined in advance.

Diminishing Musharaka: A practice where a financier and his client participate either in the joint ownership of a property or equipment, or any fixed asset. The share purchased on behalf of the financier is divided into a number of units, and it is understood that the client will purchase the share units one by one over a length of time until he is the sole owner of the property or asset.

Arbun Contract: A down payment; a nonrefundable deposit that a buyer makes to retain the right of confirming or canceling a sale.

Geographic distribution and economic power

More than 280 Islamic financial institutions now operate in over 40 countries around the world, ranging from commercial banks, investment banks, investment companies to leasing and insurance companies. The first Islamic financial institutions in the Middle East were Kuwait Finance House, Dubai Islamic Bank, Al-Rajhi in Saudi Arabia, and Faisal Islamic Banks in Egypt and Sudan. The GCC (Saudi Arabia, Kuwait, Bahrain, United Arab Emirates, Qatar and Oman) region currently remains the primary financier of Islamic finance world-wide.

In Saudi Arabia, for instance, the economy grew by 6.5 percent in 2005 – its highest growth rate since the oil boon of the 1970s. Growth was reflected in the in-

creased amounts of both personal and small business deposits in Shariah-compliant facilities. Across the Gulf in Iran, despite the country's political challenges, 2005 was a positive best year for the country's banks, which have been Shariah-compliant since 1983. Again, the boom in oil and prices lead to a gross domestic product increase of 6.1 percent. Bank Melli, Iran's largest bank and the leading Islamic bank worldwide in terms of assets, saw its total assets rise to more than $25 billion. Trade finance is especially important for Iran's Islamic banks, usually conducted on a *murabahah* basis. Many consumer imports enter Iran through the United Arab Emirates (UAE), where

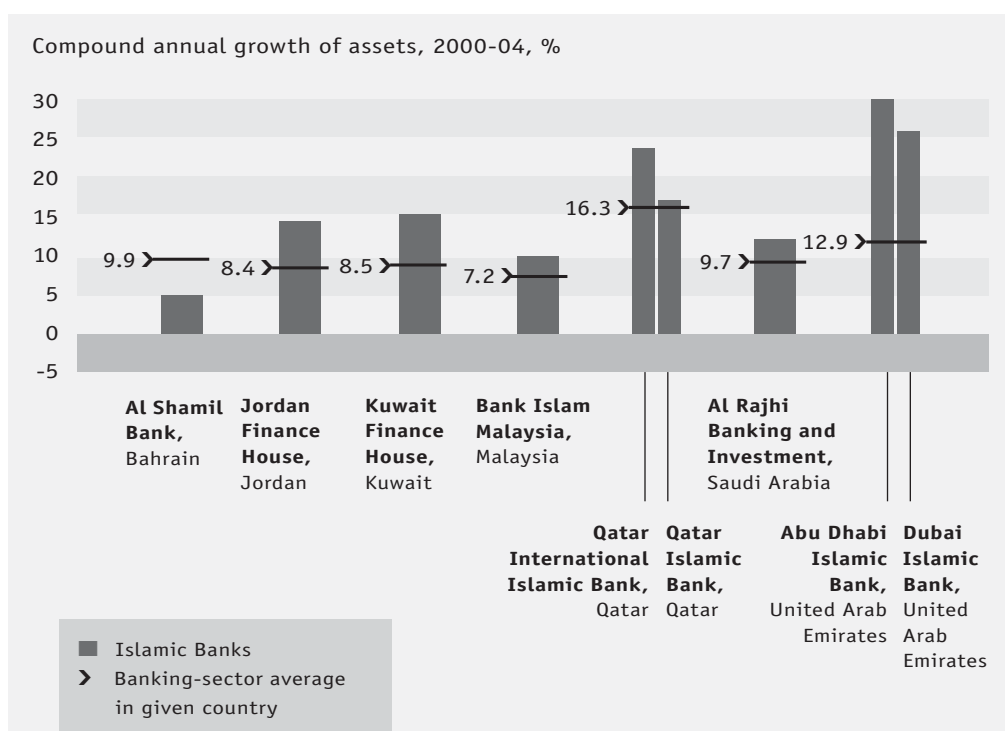
Major Islamic Banks in the Middle East and Major Banks' Growth Rates

BAHRAIN	IRAN
Bahrain Islamic Bank	Bank Melli Iran
ABC Islamic Bank (E.C.)	Bank Sederat Iran
Shamil Bank	Bank Mellat
Noriba Bank	Bank Tejarat
Gulf Finance House	Bank Sepah
Albaraka Bank Bahrain	Bank Refah
Citi Islamic Investment Bank E.C.	Export Development Bank of Iran
First Islamic Investment Bank	Bank Sanaat o Maadan
Al-Amin Bank, Bahrain	Bank Keshavarzi
	Bank Maskan
	Karafarin Bank
	Saman Bank
	Bank Eghtesad-e-Novin
	Bank Parisian
JORDAN	**KUWAIT**
Jordan Islamic Bank	Kuwait International Bank (K.S.C.)
Islamic International Arab Bank	Kuwait Finance House
	Boubyan Bank (K.S.C.)
LEBANON	**QATAR**
Al-Baraka Bank Lebanon	Qatar Islamic Bank
	Qatar International Islamic Bank
	Qatar Islamic Insurance Company
Saudi Arabia	UAE
Islamic Development Bank	Dubai Islamic Bank
Al Baraka Investment & Development Co.	Abu Dhabi Islamic Bank
Al Rajhi Banking & Development Corporation	National Bank of Sharjah

all major Iranian banks have branches. More than 4,500 Iranian businesses are active in Dubai, but the movement is not all one way.

It was only a decade ago that there were no Islamic investment banks – a number that has grown to 10. The largest Islamic investment banks are the First Islamic Investment Bank of Bahrain, the Al Tawfeek Company for Investment of Saudi Arabia, the Gulf Finance House of Bahrain and the International Investor of Kuwait. All of these institutions expanded their investment banking business substantially in 2005, reflecting the booming economic conditions in the Gulf, which has primarily been driven by oil revenue. Further, this growth exemplifies how Islamic investment banking activity is much more pro-cyclical than standard commercial banking in this region of the world.

In addition, the years of late have shown an increase in the degree of professionalism across Gulf-based Islamic investment companies. Some companies even started to seek listing on the Alternative Investment Market in London, such as the Dubai-based

Growing Faster than the Markets

Source: Annual reports of Islamic banks shown; central banks for countries shown; Global Insight; McKinsey analysis.

Islamic complaint company Tejoori – the first Shariah-complaint investment company to gain international status.

The innovation of GCC Islamic financial companies has expanded Shariah-compliant investments across all financial sectors, including real estate, industry, information technology, media and advertising, and insurance coverage, particularly for political risks.

Implications and future

In the past decade, Islamic banking has matured from a niche market into a global finance industry. As western bankers and borrowers compete for the new funds pumping into the Gulf from high oil prices revenues, this growth can be expected to continue well into the future. In 1999, there were only a dozen Islamic-branded investment funds; now there are at least 240 worldwide. The Islamic finance industry is blossoming, and as a consequence it must offer a more diverse range of services and products for middle and low-income depositors. Additionally, it must train professional managers, helping them to become well versed in both theoretical concepts and practice.

The fact that the Islamic banking industry is growing cannot be neglected, and the size of surplus money that is fueled by the oil prices in the Middle East region has encouraged international banks to be involved in Shariah-compliant investment banking, notably HSBC, Citigroup, Deutsche Bank and UBS through its Bahrain-based subsidiary, Noriba Bank.

Usually the core business of investment banking is mergers and acquisitions, corporate financial restructuring and Initial Public Offerings (IPOs), where companies seek stock market listings. There is much less of this type of business in the Gulf and other Muslim markets than in major international markets, although the stock market boom throughout the Gulf in 2005 did result in a record number of IPOs. Rather, much of the Shariah-compliant investment banking business has focused on wealth management and mutual funds, although the latter also involves retail banks, most notably the National Commercial Bank of Saudi Arabia, the largest manager worldwide of such funds on a Shariah-compliant basis.

While a few Western banks, such as HSBC, BNP Paribas, Standard Chartered and Citigroup, have been running Islamic operations for almost a decade, they are now facing competition from a host of new names. These include Morgan Stanley, Barclays Capital and Deutsche Bank – as well as smaller players, such as WestLB, which last year alone arranged around a dozen Islamic deals, worth around $4 billion.

The fast growing demand for Islamic products is not only presenting its host

of rewards, but challenges as well. As the Islamic finance market begins to mature, banks and investors are demanding new products and new structures that are complaint with Shariah principles. But while the products must be often syndicated with Shariah scholars, English and American financial lawyers are finding ways of making Islamic products work. This syndication allows the Muslims who recognize Shariah law to use and benefit from the Shariah-compliant financial tools at Western banks or companies.

Other trends in the Islamic banking industry include the increase in bond financing by Islamic governments and government agencies, and project fundraising according to Islamic principles, which forbid *riba*, or unjust enrichment. Shariah-compliant financing have been included in recent fundraising for infrastructure projects across the Middle East. For example, in Abu Dhabi, a recent project worth $2.1 billion to expand water desalination and electricity generation included $540 million of Islamic financing. Landmark investments, such as the inclusion of $55 million of Islamic financing out of $255 million by Kuwait Finance House and the Islamic Development Bank for the Al-Hidd power project in Bahrain, have also occurred.

Conclusion

Islamic banking can be main tool with accordance to Islamic principles and laws, it is based on the principle of sharing risk, and profit/loss between financial institutions and individuals.

One major difference between Islamic banks and conventional banks is the prohibition of interest on loans (*riba*), given the fact that Islam does not allow unjustified capital increases, and also it emphasizes on deriving capital increase through investment and going through full economical cycle. Revenues and profitability is usually derived from several Islamic financial products, based on sharing risk and revenues with customers, like (*murabaha*, *musharaka*, *ijara*, *tawaroq*, etc.). And Islamic banks should always refer to Shariah boards formed of Shariah scholars to determine the level of compliance of their financial products with Islamic laws.

In recent years, the number of Islamic financial institutions has grown significantly, and the demand for Shariah-compliant financial products has increased in drastic manners. Driven by the boom in oil and gas prices revenue, Islamic financial industry had evolved from a niche market to a global financial market. That boom has led to a huge growth for local Islamic financial institutions and even led international financial institutions to enter and compete in the market.

This growth and increased demand requires innovation and product development of Shariah-compliant financial products, and increase the variety of offerings.

Although there have been innovative initiations by Islamic financial institutions in several fields, like information technology, industrial projects, and even providing insurance against political risk, the industry still needs more innovative and sophisticated financial instruments taking advantage of western financial experience to streamline and standardize Shariah-compliant products. ■